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IN THE

Supreme Court of the United States

OCTOBER TERM, 1943

No. ..228

UNITED STATES OF AMERICA,
Plaintiff-Respondent,

against

THE MORRIS AND ESSEX RAILROAD COMPANY, CORA DREYFUS, LILLIAN A. NEUBERT and LAURA D. PEPPER,
Defendants-Appellants,

and

THE DELAWARE, LACKAWANNA AND WESTERN RAILROAD COMPANY,
Defendant.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT, AND BRIEF IN SUPPORT THEREOF

FREDERICK M. SCHLATER,
Counsel for Petitioners, The Morris and Essex Railroad Company, Lillian A. Neubert and Laura D. Pepper.

SAMUEL HERSHENSTEIN,
Counsel for Petitioner Cora Dreyfus.

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IN THE

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OCTOBER TERM, 1943

No. .....

UNITED STATES OF AMERICA,
Plaintiff-Respondent,

against

THE MORRIS AND ESSEX RAILROAD COMPANY, CORA DREYFUS, LILLIAN A. NEUBERT and LAURA D. PEPPER,
Defendants-Appellants,

and

THE DELAWARE, LACKAWANNA AND WESTERN RAILROAD COMPANY,
Defendant.

PETITION FOR WRIT OF CERTIORARI

To the Honorable the Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States:

Petitioners Morris and Essex Railroad Company, Cora Dreyfus, Lillian A. Neubert and Laura D. Pepper respectively pray that a writ of certiorari issue to the United States Circuit Court of Appeals, Second Circuit, to review a decision of that Court handed down in this cause on May 7, 1943.

Jurisdiction

The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925 (28 U. S. C. A., Section 347).

Opinions Below

The opinion of the District Court for the Southern District of New York is not officially reported, but is set forth in full in the record (fols. 145-52). The District Court acted on authority of a prior decision of the Circuit Court of Appeals of the Second Circuit, *United States* v. *Warren Railroad Company*, 127 Fed. (2d) 134.

The Circuit Court of Appeals affirmed with a decision handed down May 7, 1943, reported at 135 Fed. (2d) 711 and reproduced in full in the record.

Statement

No fact here is in dispute.

The Government has been granted an injunction restraining the defendant, Delaware, Lackawanna & Western Railroad Company from making any payments to the stockholders of the defendant The Morris and Essex Railroad Company which payments are due to said stockholders, pursuant to an agreement of lease made in 1868, to the end that the Government can collect therefrom income taxes which it claims are due from the corporation, The Morris & Essex Railroad Company.

It is the Government's claim that it can collect income taxes which it claims are due from The Morris and Essex

Railroad Company in the maximum amount of $2,114,084.60 from periodic rental payments due from another corporation to the some 6,000 stockholders of the petitioner The Morris and Essex Railroad Company. The procedure here adopted by the Government was suggested by the Circuit Court of Appeals in *United States* v. *Warren Railroad Company*, 127 Fed. (2d) 134.

In 1868 the petitioner The Morris and Essex Railroad Company leased all of its property for the duration of its charter to the Delaware, Lackawanna & Western Railroad Company in consideration of semi-annual payments to be made directly to the lessor's stockholders and bondholders. The lessee promised to pay the stockholders of the lessor "interest" at 7% per annum on the par value of said stock and 1% contingent additional interest. The latter provision was modified in 1917 to provide that the defendant pay ¾% interest fixed in lieu of the contingent additional interest of 1%. Since 1917, therefore, the interest paid on the stock totals 7¾%. There are now outstanding 300,000 shares of stock held by some 6,000 persons. The total payments made annually by the lessee to the stockholders of the lessor is $1,162,500. The lessee also agreed to pay the bonds and interest thereon and all other obligations due and owing by the lessor. There are now outstanding some $60,000,000 of such bonds held by the public. Upon these the lessee pays a total of $2,400,000 interest per annum directly to the bondholders.

The obligation of the lessee to pay to the stockholders of the lessor is endorsed in writing upon the certificates of stock which are also signed by the lessee.

That contractual endorsement reads in part:

> "• • • The Delaware, Lackawanna & Western Railroad Company, its successors and assigns, shall

> pay to the holders of the capital stock of The Morris & Essex Railroad Company dividends at the rate of seven and three-quarters per cent. per annum (7¾%) upon the par value of said stock * * * all of such payments to be free and clear of all taxes, assessments or impositions whatsoever" (fol. 116).

Under the clear provisions of local law the payments and the right to the payments thus required to be made by the lessee are the sole and absolute property of the stockholders of the lessor.

While the determination below granting an injunction *pendente lite* against the continuance of the payments is not a final determination in a legalistic sense, yet the merits of the controversy have been adjudicated. Further procedure is formal. If the questions here involved are to be reviewed by this Court they should be reviewed now for delay will work serious injuries to the stockholders in the event that it be held that the Government does not have the right to appropriate their property for the satisfaction of the corporation's indebtedness. The 6,000 stockholders, many of them holding a small number of shares, are dependent upon the guaranteed return from this stock for their support and maintenance. Subsequent payment of accumulated distributions will not repair the great damage and hardship occasioned by the withholding of the semi-annual payments (fols. 105-6).

Questions Presented

1. Are stockholders, as such, in the absence of fraud, liable for corporate income taxes, at the option of the Government?

2. Has Congress authorized the Government to collect corporate income taxes assessed against the corporation from its stockholders? (26 U. S. C. A., Secs. 3670, 3690, 3692.) If so, is such authorization contrary to the Fifth Amendment to the Constitution of the United States?

Reasons Why Writ Should Be Granted

1. The decision of the Court below is in conflict with applicable local decisions under which the payments are the sole property of the stockholders.

2. The decision of the Court below is in conflict with applicable decisions of this Court.

3. This is a test case of general importance; there are now pending some nine similar actions involving total annual payments to stockholders of lessor railroads of $2,840,772.

4. Serious hardship and injury will result from the mere withholding of the payments should it later be determined that the Government has no right to collect from present stockholders corporate income taxes assessed by reason of payments made to former stockholders as well as taxes presently accruing.

WHEREFORE your petitioners respectfully pray that a writ of certiorari be issued out of and under the seal of this Court directed to the United States Circuit Court of Appeals for the Second Circuit commanding said Court to certify and send to this Court on a day to be designated a full transcript of the record of all proceedings of the said Circuit Court of Appeals in this cause to the end that this

case may be reviewed and determined by this Court; that the judgments and orders of the said Circuit Court of Appeals for said Circuit be reversed and that petitioners be granted such other and further relief as to this Court may seem just and proper.

THE MORRIS AND ESSEX RAILROAD COMPANY,
LILLIAN A. NEUBERT and LAURA D. PEPPER,

By FREDERICK M. SCHLATER,
Counsel for Petitioners.

CORA DREYFUS,

By SAMUEL HERSHENSTEIN,
Counsel for Petitioner.

BRIEF IN SUPPORT OF PETITION

Statement

The petition contains a statement of the facts and circumstances here pertinent.

Specifications of Error

The Circuit Court of Appeals for the Second Circuit erred in the instant case:

1. In failing to give effect to the local law that the payments made by a third person to stockholders of a corporation belonged to such stockholders absolutely and in their own right.

2. In holding that the Government may, as a matter of course, collect the income taxes out of any income upon which the taxes were computed.

3. In holding that the corporate income taxes of the lessor could be collected out of the personal property of its shareholders.

4. In holding that present shareholders are personally responsible for income taxes which accrued by reason of payments made to former stockholders.

POINT I

Under clear local law the payments from the lessee to the stockholders of the lessor are their sole and absolute property and cannot be appropriated by the Government or any other creditor of the lessor.

The purposes of all parties in 1868, when the lease was made, are clear from what they did.

As to Stockholders. Of necessity, the lease had to be satisfactory to the stockholders since it could not have been made against their consent. It worked an entire transformation in the nature and character of their securities. To each stockholder it was of prime importance that the stipulated fixed payments be placed completely beyond the power of the lessor, their fellow stockholders and the directors of the lessor to invade or imperil. This accounts for the provision that the payments be made directly to each stockholder in his own right. Unquestionably under local law this made the payments free of any future debts or liabilities of the lessor corporation. Furthermore, the lessee assumed the responsibility of paying all outstanding and prospective obligations of the lessor. This was accomplished, first, by the terms of the lease, and, second, by the contract of payment endorsed upon the certificates themselves.

As to the Lessee. The lessee financed its acquisition of the property of the lessor by obligating itself to make stipulated payments of "interest." It will be noted that while the lease refers to payments to be made to stockholders as "interest," the endorsement on the certificates refers to them as "dividends." They, clearly, are not dividends

since they represent no share in the profits and are paid by the corporation to persons who are not its stockholders.

As to the Lessor. It was to be, and was, retired entirely from business. The difficulty that has arisen here is occasioned by the levy of taxes upon a corporation which engages in no business and which is entirely dormant, if not dead, and which has no funds or property except the reversion under the lease.

(a) *The Government as a creditor has no greater rights than the lessor.*

For each and every purpose the Government stands in the shoes of the lessor. The Government here is a creditor, although of course it has priority as against other creditors. *Price* v. *United States* (1926), 269 U. S. 492. "Income taxes, apart from the right of preference in payment, are but debts" (*United States* v. *Western Union Telegraph Co.* (1931) (2d) Circuit, 50 Fed. 2d 102).

In *United States* v. *Warren R. Co.*, 127 Fed. (2d) 134, 137, where the facts were similar to those here presented, the Court below said, "It (the Government) can, however, have no right under any theory beyond that of the lessors themselves."

(b) *The Lessor is Powerless to Touch the Payments due to the Stockholders—and so is the Government.*

The Court below has exercised the powers of a Marshal in seizing property in satisfaction of a claim which the Government has against the lessor. The seized property does not belong to the taxpayer. It belongs to the stockholders absolutely and in their own right. This presents a question of title where the local law is not only to be followed (*Erie Railroad* v. *Tompkins,* 304 U. S. 64), but

is wholly controlling (*Freuler* v. *Helvering*, 291 U. S. 35; *Lyeth* v. *Hoey*, 305 U. S. 188; *Poe* v. *Seaborn*, 282 U. S. 101).

The stockholders do not take the payments through the lessor. Their rights vested 75 years ago. By no conceivable action may the lessor, the lessee and all the other 6,000 stockholders of the lessor rightfully deprive a single stockholder of his right to the payments contracted to be paid to him directly. This is indisputably true under the laws of the State of New York and New Jersey, whichever is controlling. (We believe it better to meet the problem this way than to attempt to determine whether the law of New Jersey or New York controls. The lessee is a Pennsylvania corporation. The lessor is a New Jersey corporation. The property concerned is located in New Jersey. The lease was acknowledged before a Master in Chancery in New Jersey, but, apparently, in New York City.)

Local cases where the facts were less clear and strong in favor of the stockholders are:

Nina H. Peabody v. *Interborough Rapid Transit Company*, 124 Misc. 801, affirmed 213 App. Div. 857, affirmed (1925) 240 N. Y. 708; *Bowers* v. *Interborough Rapid Transit Company* (1923), 121 Misc. 250, affirmed 208 App. Div. 768. In those cases the lease was less favorable to the stockholders for it required the lessor to declare a periodic dividend equal to each installment of rent. Some years after making the lease, the lessee enjoyed less earnings than had been anticipated and had become financially embarrassed. In order to avoid receivership, it was proposed that the stockholders of the lessor accept 5% in lieu of the 7% contracted for. The lessee, the lessor and 90% of the stockholders of the lessor consented and the lease was subsequently amended. The dissenting stockholders were successful in collecting the full amount of the dividends payable to them under the

original lease under the law of the State of New York that they as third party beneficiaries had obtained vested rights of which they could not be deprived without their consent. Other cases decided by the highest Court of the State of New York are: *Gifford* v. *Corrigan,* 117 N. Y. 257; *Seaver* v. *Ransom,* 224 N. Y. 233, where it was held that the third party beneficiary obtained a vested and indestructible right which could not be defeated without his consent.

The law of New Jersey is the same as New York. *Bijur* v. *Standard Distilling Co.,* 74 N. J. Eq. 546, 70 A. 934, aff'd 78 N. J. Eq. 582; *Fleming* v. *Reed,* 77 N. J. L. 563. In one further respect the law of New Jersey is even more favorable to the stockholders than that of New York. In New Jersey a lease in perpetuity is, in legal effect, a conveyance for the purposes of the questions here presented. *Wilson, et al.* v. *Moorland Farms Corp., et al.,* 102 N. J. Eq. 425, 427; *Black* v. *Delaware and Raritan Canal Co.,* 24 N. J. Eq. 455. The very lease here involved was adjudged by the Court below in *Anderson* v. *Morris & Essex R. Co.,* 216 Fed. 83, as follows: "The lease for all practical purposes was a conveyance in fee."

In legal contemplation, therefore, for all questions here presented, seventy-five years ago the lessor conveyed its property to the lessee upon the lessee's agreement to pay the purchase price directly to the stockholders of the lessor. Now the Government attempts to take from these stockholders property which vested in them at the time of the conveyance on account of claims that arose against the taxpayer years subsequent to the date of the conveyance.

The Court below refused to follow its prior decisions in *United States* v. *Western Union Telegraph Co.,* 50 Fed. (2d) 102; *Harwood* v. *Eaton,* 68 Fed. (2d) 12; *Western*

Union Telegraph Co. v. *Commissioner,* 68 Fed. (2d) 16, wherein it did follow and apply the local law.

Other Circuit Court of Appeals have held that where a beneficiary of a revocable policy of insurance, under local law, has some right in the policy, its cash surrender value may not be taken by the Collector to satisfy an income tax claim against the insured. (*Cannon* v. *Nicholas* (10th Circuit), 80 Fed. 2d 934; *Kyle* v. *McGuirk* (3rd Circuit), 82 Fed. 2d 212.)

POINT II

Because an income tax may be assessed upon certain income, it does not necessarily follow that the Government may collect the tax from that income.

The distinction we wish to emphasize is the difference between the assessment of an income tax and collecting it. An income tax may be assessed upon income received, income fictitiously or constructively received, but it may be collected only out of and from the property of the taxpayer or debtor.

There are many circumstances in which a person may be taxed upon income constructively—fictitiously—received. Under prior statutes a man who, upon a divorce, established a trust fund for his wife in lieu of alimony was taxed upon the income of the trust (*Douglas* v. *Willcuts,* 296 U. S. 1). Of course, the Congress might assess, as it now has, an income tax against the wife computed upon her receipt of the income; but Congress cannot assess the husband with a tax computed upon such income and collect the husband's tax out of the wife's property. In the case

at bar, the individual stockholders pay their own income tax upon the payments they receive. The objection is to the attempt to compel them to pay another's income tax, too.

Another illustration is where a trust is revocable by a person not having an interest substantially adverse to the grantor, the income is taxable to the grantor (26 U. S. C. A. 166, Reg. 103, § 19.167-1). The Government could, of course, tax the beneficiary but it cannot collect the grantor's income tax from the beneficiary of the trust.

Again, take the case of a man who spent not only the salary which he has earned in one year but has assigned subsequently accruing salary for a consideration and has spent that, too. The Government cannot collect the assignor's income tax from the assignee.

Yet, the Court below held that since the Government had a right to assess an income tax upon the lessor measured by the distributions to the shareholders "it must follow that they (future distributions) are available to satisfy the tax; for it would be absurd at once to hold that the dividends were the lessor's income for the purpose of assessing a tax against it, but were the shareholder's income for the purpose of collecting that very tax." As above demonstrated, this premise upon which the Court below expressly proceeded is false. In so far as it asserts that every creditor *should be paid,* we agree, but we think only out of the property of his debtor and if that is impossible the creditor must remain unpaid.

It does not follow that, because there are many situations where a taxpayer's relationship to the person or to the income may be such as to justify Congress in imposing a tax upon a particular taxpayer measured by certain in-

come which belongs to another, Congress may thereby appropriate the property of that other person to satisfy the debt owed by its taxpayer.

This Court, in *Joliet & Chicago R. Co.*, 86 L. Ed. 658, 315 U. S. 44, held that even though the rights of shareholders vested in 1864 and the lessor corporation had no right to control the payments to its stockholders and even though the lessor did not own or control the property, an income tax *measured by* such payments could be assessed against the corporation. This Court recognized the distinction between assessing an income tax and collecting it for this Court said: "Such considerations do not dispose of this controversy," which was one of assessing a tax. The Court pointed to a Treasury regulation in effect since 1914 and unchanged by Congressional action which was clearly applicable and "if valid it governs this case whatever may be the legal incidents of the 1864 Indenture under the Illinois law." Finding that the regulation was valid, the assessment of the tax was upheld. But neither that case, nor any other, holds that an income tax due from one taxpayer can be collected from the property of another even though the taxpayer's relationship to the person receiving the income or to the property may be such as would constitutionally support an assessment against him. In other words, an income tax is simply a debt and can be collected only out of the property of the debtor. As far as collectibility of tax is concerned, the ownership of property is determined by local law.

The statutes are specific in limiting the collection of taxes from the property of the taxpayer. The Collector is given authority to proceed "by distraint and sale in the manner provided in this subchapter of the goods, chattels or effects including stocks, securities, bank accounts and

evidences of debt, of the *person delinquent* as aforesaid" (26 U. S. C. A., Sec. 3690). The statute also provides for a lien "in favor of the United States upon all the property and rights to property, whether real or personal, belonging to such person (delinquent taxpayer)" (26 U. S. C. A., Sec. 3670).

Congress has granted no power to anyone to satisfy a claim for income taxes out of the property of any person except that of the taxpayer. But the Court below has.

POINT III

Stockholders of a corporation are not personally responsible for corporate income taxes.

The Court below regarded the corporate entity for the purpose of assessing a tax but disregarded it for the purpose of collecting the tax. Citing *Higgins* v. *Smith*, 308 U. S. 473, as authority, it announced the novel principle that the Treasury at its option may disregard the corporation and hold the shareholder liable for corporate income taxes. We submit that *Higgins* v. *Smith* is authority for no such proposition. It was there held only that a taxable loss was not sustained where an individual "sold" property to a corporation the stock of which was entirely owned by him. This Court in *Moline Properties, Inc.* v. *Commissioner of Internal Revenue*, 87 L. Ed. 1071, announced the rule limiting the Treasury's right to disregard the corporate form as follows:

> "In general, in matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal. In such situations the form is a bald and mischievous fiction. *Higgins* v. *Smith*, 308

U. S. 473, 477, 478, 84 L. ed. 406, 410-412, 60 S. Ct. 355; *Gregory* v. *Helvering*, 293 U. S. 465, 79 L. ed. 596, 55 S. Ct. 266, 97 A. L. R. 1355."

Here there is no claim of fraud or even of devious conduct. The property rights in question vested in the predecessors of these stockholders seventy-five years ago through an ordinary business transaction completed in the utmost good faith and without any idea of avoiding tax.

POINT IV

In any event the Government may not collect from present stockholders income taxes due by reason of distribution to former stockholders.

The Government seeks to collect income taxes due from 1934 to 1941, both inclusive. These taxes are measured by distribution to stockholders in each of those years. Under the decision below income taxes due by former stockholders will be collected from present stockholders. Under any view of the case one person's income tax is being paid out of the property of another.

IN CONCLUSION

It is respectfully submitted that for the foregoing reasons this Court should grant the writ of certiorari as prayed for in the petition.

FREDERICK M. SCHLATER,
Counsel for Petitioners, The Morris and Essex Railroad Company, Lillian A. Neubert and Laura D. Pepper.

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No. 228

UNITED STATES OF AMERICA,
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against

THE MORRIS AND ESSEX RAILROAD COMPANY, CORA DREYFUS, LILLIAN A. NEUBERT, and LAURA D. PEPPER,
Defendants-Appellants,

and

THE DELAWARE, LACKAWANNA AND WESTERN RAILROAD COMPANY,
Defendant.

REPLY BRIEF ON BEHALF OF PETITIONERS

The Government rests its case upon a theory which the Court below repudiated. The Government's position is that the Statute involved is 26 U. S. C. A. Section 3710. The Court below in *United States* v. *Metropolitan Life Insurance Co.*, 130 Fed. (2d) 149 held that the Government could not in distraint proceedings enter judgment against a third party for the amount of a debt or an obligation to pay money due to the taxpayer. That holding was expressly adhered to in the opinion below (R. 63-4).

Moreover, the payments due to the stockholders were not property which was "subject to distraint" because the taxpayer has no right whatever to the payments in question. Those rights irrevocably vested in the stockholders and their predecessors seventy-five years ago. So far as we are advised the Government has never before claimed that it could collect the proceeds of an *irrevocable* insurance policy payable to a third party beneficiary in satisfaction of the insured's income taxes. Yet that is the effect of the judgment below. In fact it has been held in other Circuits that the Government may not reach the cash surrender value of even a *revocable* insurance policy. *Cannon* v. *Nicholas* (10th Circuit), 80 Fed. (2d) 934; *Kyle* v. *McGuirk* (3rd Circuit), 82 Fed. (2d) 212.

It is respectfully submitted that this Court should grant the writ of certiorari as prayed for in the petition.

FREDERICK M. SCHLATER,
Counsel for Petitioners, The Morris and Essex Railroad Company, Lillian A. Neubert and Laura D. Pepper.

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United States v. *Warren R. Co.*, 127 F. (2d) 134 — 6, 7

Statute:

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Section 3710 (26 U. S. C. sec. 3710) — 2

548989—43

In the Supreme Court of the United States

OCTOBER TERM, 1943

No. 228

THE MORRIS AND ESSEX RAILROAD COMPANY, CORA DREYFUS, LILLIAN A. NEUBERT AND LAURA D. PEPPER, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the District Court (R. 49–51) is not reported. The opinion of the Circuit Court of Appeals (R. 61–65) is reported in 135 F. (2d) 711.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered May 24, 1943 (R. 65–66). The petition for a writ of certiorari was filed August 5,

1943. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended.

QUESTION PRESENTED

The taxpayer leased all of its properties to another corporation for the duration of the lessor's corporate charter. The lease provided for the payment of stated dividends by the lessee directly to the stockholders of the taxpayer. The Commissioner of Internal Revenue assessed income taxes for the years 1933–1941, inclusive, against the taxpayer in respect of its taxable net income consisting of the payments to the stockholders, but the assessments (except the original tax for 1933) have not been paid. Was it error for the District Court to grant a preliminary injunction enjoining the lessee from paying further rental dividends to the stockholders until the Collector could levy thereon for the purpose of effecting collection of the unpaid assessments?

STATUTE INVOLVED

Internal Revenue Code (26 U. S. C., sec. 3710):

> SEC. 3710. SURRENDER OF PROPERTY SUBJECT TO DISTRAINT.
>
> (a) *Requirement.*—Any person in possession of property, or rights to property, subject to distraint, upon which a levy has been made, shall, upon demand by the collector or deputy collector making such levy, surrender such property or rights to such

collector or deputy, unless such property or right is, at the time of such demand, subject to an attachment or execution under any judicial process.

* * * * *

STATEMENT

In 1868, the Morris and Essex Railroad Company, a New Jersey corporation, the taxpayer petitioner,[1] leased all of its properties to the Delaware, Lackawanna and Western Railroad Company, a Pennsylvania corporation, for the full term of the continuance of the lessor's corporate charter and any renewals thereof, conditioned upon payment by the lessee of interest upon the lessor's bonds and capital stock (R. 17–29). The original lease provided that the "interest" upon the capital stock would be 7% per annum, payable semi-annually directly to the stockholders (R. 21). In 1917, the lease was amended to provide for payment of dividends upon the lessor's capital stock at the rate of 7¾% per annum, 4¼% payable on January 1 and 3½% on July 1 (R. 34). The portion of the lease providing for the payment of dividends was printed on the back of the stock certificates (R. 39). The lessee promised to pay any income taxes "on the income or profits of the said business" (R. 20).

The instant action was brought against the taxpayer and the lessee for the purpose of effect-

[1] The other petitioners are intervening shareholders of the taxpayer corporation (R. 62).

ing collection of delinquent income taxes assessed against the taxpayer for the years 1933–1941, inclusive, such claims aggregating $2,114,084.60, with interest, or alternatively, in the event the lessee was not obligated to pay the lessor's income taxes, $1,751,940.96, with interest (R. 8–17). Among the prayers of the complaint was one asking that the lessee be restrained from paying rental dividends to the stockholders of the lessor railroad until the Collector could levy thereon for the purpose of satisfying the Government's tax claims (R. 16). Another prayer asked that the lessee be ordered to pay to the Collector upon demand the rental dividends (R. 16–17). The complaint asserted that by reason of the assignment and conveyance of the taxpayer's properties to the lessee pursuant to the terms of the lease between the parties, the taxpayer was insolvent and without assets or properties against which the Government could institute proceedings to effect the collection of its claims (R. 14).

In opposition to the Government's motion for the preliminary injunction, counsel for the taxpayer filed an affidavit which does not deny that the taxes assessed by the Commissioner are due and owing as alleged in the complaint (R. 32–37). Likewise, the affidavit of petitioner Cora Dreyfus, one of the taxpayer's shareholders, fails to challenge the taxpayer's liability for the assessments (R. 46–48). The affidavit of the Assistant United

States Attorney supporting the motion for the preliminary injunction asserted that if the lessee were permitted to carry out its intention of paying the dividends due on January 1, 1943, to the stockholders of the lessor, the only asset of the lessor from which the income taxes could readily be satisfied would be diverted and such payment and diversion would work an immediate serious and irreparable damage and injury to the plaintiff (R. 6–7).

The District Court granted the injunction (R. 49–55), and the Circuit Court of Appeals affirmed (R. 65–66).

ARGUMENT

The taxpayer had leased all its properties and the lessee agreed to pay rent in the form of dividends or "interest" to the taxpayer's stockholders. Such payments constitute taxable income to the taxpayer (*United States* v. *Joliet & Chicago R. Co.*, 315 U. S. 44). However, since the taxpayer had no other free assets out of which the taxes could be paid, it was entirely appropriate for the District Court, in the exercise of its equity powers, to enjoin the diversion of those rental payments to the taxpayer's stockholders until the tax liability is satisfied.

The petition erroneously assumes (Pet. 11) that the funds sought to be reached have already become the property of the stockholders. Both the Government and the stockholders are claimants of

the funds. The Government has a claim against the lessor-taxpayer and the latter has agreed that the rental income which would otherwise be received by it, and thus be available to satisfy the demands of the Collector, shall be paid directly to the stockholders. The lessee proposes to pay this rental income to the stockholders, and the question is whether the Government may intervene and prevent the payment. The taxpayer has no funds to satisfy the tax claim (R. 54), and if the payment is not enjoined the Government may be without a remedy. Cf. *United States* v. *Warren R. Co.*, 127 F. (2d) 134 (C. C. A. 2); *Harwood* v. *Eaton*, 68 F. (2d) 12 (C. C. A. 2), certiorari denied, 292 U. S. 636. The District Court found that taxes are due the United States in excess of the annual rents payable and that the injunction is necessary to prevent irreparable injury (R. 53–54).

The rental income involved is that of the lessor-taxpayer and the rights of the stockholders are purely derivative. *United States* v. *Joliet & Chicago R. Co., supra.* Petitioners assume that, by action which is in effect the declaration of dividends in the amount of its entire income, a corporation can create rights in the stockholders superior to the tax claims of the Government (Pet. 9–12). This view is not supported by any authority and is clearly without merit.

Petitioners' argument that the stockholders have vested rights as against the United States is predicated (1) upon decisions of the New York and New Jersey courts that the stockholders have such rights as against the corporation, and (2) upon the assumption that the stockholders do not take the payments through the lessor (Pet. 10). However, this theory is squarely opposed to the decision in the *Joliet & Chicago R. Co.* case.

Accordingly, the stockholders stand here as mere claimants, competing with the United States for funds in the possession of a third party. Where the funds belong to a taxpayer it is the declared policy of Congress that the United States is entitled to possession as against other claimants (Section 3710 of the Internal Revenue Code, *supra,* pp. 2–3). The decision that the payment to the stockholders should be enjoined is in harmony with that policy. *United States* v. *Warren R. Co.,* 127 F. (2d) 134 (C. C. A. 2).

CONCLUSION

The decision below is correct, and no conflict of decisions or question of general importance is

involved. The petition for a writ of certiorari should therefore be denied.

Respectfully submitted.

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End

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